May 2019

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

Global financial markets had been recovering strongly from the turbulence of late last year but have given up some their gains following the latest round of US-China tariff increases. There have been some signs of activity stabilising – Q1 GDP in some major economies was either stronger or unchanged, and the global composite PMI has basically moved sideways this year. However, our leading indicator of global activity continues to point to a slowdown in growth. Given this, and the flare up in the US-China trade dispute last week, we have lowered our forecasts for global growth in 2019 to 3.3% (3.4%). We then expect growth to slowly return to its long-term trend, rising to 3.4% in 2020 (revised from 3.5%) and 3.5% in 2021. This projected return to trend reflects expected supportive policy settings, a fading impact from trade measures announced to-date, and a recovery from country/region specific shocks that have been weighing on growth (notably within the Eurozone and Latin America). Trade remains one of the key risks to the outlook.

- **Financial markets** had been recovering strongly from the turbulence of late last year, with advanced economy equity indices (on average) regaining much of their lost ground, before the flare up in US-China trade tensions. Credit spreads have also narrowed and as a result measures of overall financial conditions have improved. However, some of these gains have been unwound following the US move last Friday to raise tariffs on around US$200b of Chinese imports and China's subsequent retaliation.
- This improvement in conditions has been helped along by a change in stance by many **central banks**. It is not so much about what they have done – policy rates are largely unchanged. Rather, expectations of future rate rises have been dialled back. The Fed has removed its tightening bias and is now indicating it will be 'patient' (we expect no move in either direction over the next two years), while the European Central Bank and the Bank of Japan have pushed out their forward guidance on when rates may rise. Moreover, the EM tightening cycle – which was modest in terms of duration and degree – is over and there has been some net easing in EM economies (principally driven by India). The Bank of England is an exception as it is projecting rate rises, but even there, with Brexit uncertainty still high, imminent action appears unlikely. Markets are generally even more dovish than the central bank guidance (for example, pricing in a Fed rate cut this year). This has contributed to a fall in long-term bond yields, which remain well below their peaks of last year.
- There were signs of an improvement in **major advanced economy** (AE) growth early in 2019. There was a pick-up in quarterly GDP growth in Q1 in the US, Euro-zone and the UK. While Q1 expectations for Japan are weaker, overall around 2% yoy growth for the major AEs is likely, up from 1.9% yoy in Q4 2018. However, we expect the lift in the annual growth rate will be temporary. The US performance in Q1 was boosted by some transitory factors and a fading fiscal policy boost, the (lagged) effect of past monetary policy tightening, as well as supply constraints, should lead to lower growth over 2019 than seen last year. The improvement in the Euro-zone's and UK growth rate in Q1 has not been matched by the business surveys, which point to more sluggish growth in Q2. The intensification of the US-China trade dispute will be an additional headwind to AE growth. Despite the growth slowdown in AEs (outside of the US) over 2018, labour markets have continued to hold up well.
- **Emerging market economies** (EM) have been hit hard by the slowdown in global growth as it has been centred around trade sensitive manufacturing. While overall EM exports have been falling, and industrial production (IP) slowing through to February, there were some signs that the worse may be over. The EM manufacturing PMI has moved higher in recent months, consistent with some pick-up in IP growth. China data for GDP (data to Q1 2019) and IP (data to April) also point to growth stabilising (even with the March spike in IP being short lived). However, the intensification of the US-China trade dispute that occurred last week risks re-starting a downward cycle in trade and the manufacturing sector. A key issue to watch will be how China's authorities respond to offset the negative impact on the economy.
- **Globally,** the lift in US tariffs on China imports represents an additional headwind to growth, which we have incorporated into our forecasts. It is possible that the US and China will reach some agreement in coming weeks, but equally the dispute could worsen. Moreover, there is a risk trade disputes could broaden to other US trading partners, suggesting trade related uncertainty will be an enduring feature for a while to come. Our leading indicator of global activity has also been highlighting downside risks to our forecasts for a while, although it does show growth stabilising later in the year, and business expectations continue to ease. As a result, we have lowered our forecasts for global growth in 2019 to 3.3% (3.4%), and in 2020 to 3.4% (from 3.5%). We are still projecting 3.5% growth in 2021.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>: Ahead of the Q1 national accounts to be released next month we have left our forecasts largely unchanged with the exception of a weaker inflation outlook. We still see relatively weak growth, low inflation and a stable-to-deteriorating labour market over the next couple of years. Consumption will likely only grow modestly on the back of household restraint and dwelling investment is likely to decline substantially as the housing market continues to cool. Against this, we expect exports to support growth in the near term, with growth in public demand and strength in the business sector to support growth further out. That would see employment growth slow and a small deterioration in the unemployment rate from 2020. With remaining spare capacity in the labour market and the economy more broadly, we expect inflationary pressure to remain weak, only building to the bottom of the RBA's target band by the end of 2021. In this environment while we expect a series of imminent rates cuts - we have moved the timing forward to June and August. We also see the need for additional monetary stimulus in early 2020. In brief, there is little constraint from the risk of high inflation, but there is a need to see faster rates of growth and lower unemployment.

- With our outlook for below trend growth, and below-target inflation combined with little further improvement in the labour market, we expect a series of imminent rates cuts - we have moved the timing forward to June and August. We also see the need for additional monetary stimulus in early 2020. In brief, there is little constraint from the risk of high inflation, but there is a need to see faster rates of growth and lower unemployment. The RBA has been signalling that with inflation undershooting the labour market would need to strengthen. The reverse has happened – both in our April Business Survey and the official unemployment data for April. And given our forecasts we expect that additional monetary stimulus will be needed by early 2020 – either by way of another cut or alternative means. We expect this rationale will be further highlighted in the upcoming minutes of the RBA May meeting and the Governor's speech early next week.
- An updated set of indicators of **business investment** will be released later in the month, which will provide an important marker on how business activity is travelling. The NAB Monthly Business survey suggests that the sector has lost significant momentum, with business conditions now just below average and confidence as well as other forward-looking indicators even weaker. Capacity utilisation is now around average – but significantly below the levels seen in 2018, suggesting a less positive outlook for capex and employment. The goods distribution industries – retail and wholesale – remain weakest (and negative). The services sector and eastern states appear to have held up better with conditions remaining highest in these states.
- **Consumption** growth looks to have remained weak in Q1. While monthly retail sales data has been volatile, quarterly real retail sales fell by 0.1% in the March quarter (after a flat outcome in the prior quarter). With retail sales accounting for around 30% of consumption, it is likely that the national accounts measure of household consumption (which also includes spending on services) will again be weak. Going forward we continue to see household consumption constraining overall growth in the economy, with ongoing weak wage/income growth expected to persist in addition to already high debt levels and weaker consumer confidence. Ongoing falls in house prices also present a risk of further weakness in consumption.
- The cooling in the **housing market** has continued with prices continuing to fall and activity data showing a slowing in the sector. Capital city house prices have now declined by around 10%, led by a 15% decline in Sydney and a fall of around 11% in Melbourne. Approvals for new building continue to trend down while loan approvals have also weakened. We expect the Q1 national accounts to show another substantial decline in dwelling investment, in line with our view of a 20% decline over the next two years. For now, we see the adjustments in the housing market as having occurred in an orderly fashion and prices declining by another 5% in aggregate.
- **Recent labour market data has softened a little though employment growth has remained solid.** The unemployment rate ticked up to 5.2% in April, with a rise in employment of 28k (up 323k on a year ago). By state, NSW and Vic continue to see the lowest unemployment rates – well below 5%. The other mainland states remain clustered around the 6.0% mark, while Tasmania is highest at closer to 7%. Despite the relatively low level of unemployment, the underemployment rate has deteriorated and wage growth has remained modest - with the WPI increasing by 0.5% in the March quarter, to be 2.3% higher over the year. Going forward, we expect the labour market to deteriorate sightly from 2020, with the prior slowing in GDP growth beginning to flow through.
- We estimate net exports will contribute 0.2-0.3ppt to GDP growth in the March quarter following the subtraction in Q4. Going forward we expect LNG exports to continue to support growth as the last of mega-projects reaches full production, after which point exports are likely to level off for a period.
- Our outlook for **commodity prices** is broadly unchanged; iron ore prices have held up on supply constraints, coking coal remains elevated and thermal coal has also risen more recently. The NAB Rural Commodities Index rose 1.1% in April, largely reflecting higher cattle, lamb, dairy and cotton prices, offsetting further declines in grain.
- The **AUD/USD** has traded around the US70c mark for much of the past month, before declining on the back of renewed trade tensions. We expect the Aussie to end the year around US75c before drifting up further to US79c over 2020 but it may well be the case that it sees a period below the 70c mark.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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